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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
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SANDRA D. KENNEDY
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ARIZONA CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS AGUA FRIA
WATER DISTRICT, HAVASU WATER
DISTRICT, MOHAVE WATER DISTRICT,
PARADISE VALLEY WATER DISTRICT,
SUN CITY WEST WATER DISTRICT AND
TUBAC WATER DISTRICT.

DOCKET NO. W-01303A-08-0227

Arizona Corporation Commission
DOCKETED

MAY 15 2009



IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
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WASTEWATER DISTRICT.

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STAFF'S REPLY BRIEF

The Utilities Division of the Arizona Corporation Commission ("Staff") files its reply brief. The purpose of this Reply Brief is not to repeat every point made in Staff's Initial Closing Brief, nor will it attempt to refute every single issue raised by Arizona-American Water Company ("Arizona-American" or the "Company"), instead relying upon its testimony on those issues not specifically addressed in this Reply Brief. The recommendations of Staff and its positions have been outlined in its Closing Brief as well as its testimony. Staff will highlight some of the major points of disagreement with the Company in this brief.

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...

1 **I. ALLOWING \$25 MILLION OF CONSTRUCTION WORK IN PROGRESS**
2 **ASSOCIATED WITH THE WHITE TANKS PROJECT IS INAPPROPRIATE.**

3 As the Staff pointed out in its Initial Brief, Arizona-American proposes to include \$25 million
4 of Construction Work in Progress ("CWIP") in rate base.¹ There is no doubt under Arizona law, that
5 the Commission has the discretion to include CWIP in rate base.² However, under well established
6 ratemaking principles, inclusion of CWIP in rate base is the exception, not the rule. The question that
7 needs to be asked then is does the Company meet the criteria for extraordinary treatment of CWIP.
8 Staff's position is that the Company does not meet these criteria.

9 One of the few instances where the Commission has authorized CWIP in rate base was in
10 1984 when the Commission allowed Arizona Public Service Company ("APS") to include CWIP
11 associated with the Palo Verde ("PV") nuclear generating plant in its rate base.³ However, there were
12 extraordinary circumstances facing APS at that time related to the tremendous investment in Palo
13 Verde and its associated CWIP balance. Because of those extraordinary circumstances the
14 Commission was guided more by "the economic benefits to ratepayers from further CWIP inclusion
15 and the avoidance of 'rate shock' in the APS service territory."⁴ The Commission was apparently
16 dealing with approximately \$600 million in CWIP associated with Palo Verde. From the evidence
17 presented in that case the Commission determined that inclusion of CWIP in that case would
18 "substantially reduce costs which would otherwise be properly chargeable to ratepayers."⁵ The
19 Commission viewed inclusion of some CWIP in APS' rate base to be appropriate given the
20 extraordinary circumstances in the case:

21 Even if the commission were to accept RUCO's and CREE's estimates
22 for the total value of Palo Verde, we are still faced with nearly doubling
23 APS' rate base in little over two (2) years. Unless substantial efforts
24 are made to phase in this tremendous investment over a longer period,
25 the APS service territory faces a significant potential for economic
disruption. CWIP inclusion is the logical first step for such a phase-in.
Indeed, any commission which contemplates some sort of rate
moderation program involving a post commercialization phase-in of

26 ¹ Staff Opening Brief at 6.

27 ² See *Arizona Community Action Association v. Arizona Corporation Commission*, 599 P.2d 184
(1979).

28 ³ See *In Re Arizona Public Service Company*, Decision No. 54247, 64 P.U.R.4th 147 (Nov. 28, 1984).

⁴ Decision No. 54247, at 19.

⁵ *Id.*

1 plant investment (a clear violation of the 'used and useful' doctrine)
2 should equally consider beginning its program during the
3 precommercialization phase of construction, i.e., DWIP. This will
4 spread the increase over an even longer period of time without
5 accumulating the substantial level of deferred costs which ordinarily
6 accompanies delays in recognizing plant investment.

7 In consideration of the above discussion, we find that an additional
8 \$200 million in PV-I CWIP should be included in APS' "fair value"
9 rate base. Although this still leaves some \$400 million in PV-I costs to
10 be addressed upon the in-service date of that facility (as well as the
11 costs of PV-II and PV-III), any greater amount might tend to cause rate
12 shock today in an effort to avoid it tomorrow.⁶

13 This case, in turn, has none of the attributes of the APS case in which CWIP was allowed.
14 The Company, taking a cue from a series of questions posed by Judge Wolfe to Staff witness Gerald
15 Becker, cites the prospect of rate shock as a reason to depart from Commission policy of disallowing
16 CWIP in rate base.⁷ The inclusion of the \$25 million does not raise the same concerns of "rate
17 shock" as inclusion of \$200 million or \$600 million over two years, the scenario the Commission was
18 presented with in the APS case. It is small wonder in the APS case that the Commission desired to
19 ameliorate the impact upon ratepayers with \$600 million in rate base ultimately at issue.

20 The Commission properly addressed the Company's financial expenditure and recovery in the
21 White Tanks Decision. The Company has not met the burden of proof by demonstrating
22 extraordinary circumstances to warrant the inclusion of CWIP.

23 **II. STAFF'S RECOMMENDATION REGARDING EXCLUSION OF THE WISHING**
24 **WELL PLANT AS POST TEST YEAR PLANT IS REASONABLE AND SHOULD BE**
25 **ADOPTED.**

26 The Company's position on the Wishing Well Treatment Plant has changed during the course
27 of this proceeding. In its direct testimony, the Company claimed that the work done to the Wishing
28 Well Plant was "expansion" based on growth projections.⁸ In its rebuttal testimony, the Company's
29 position was that the work for Wishing Well was to replace degraded components as well as
30 expansion.⁹ During the hearing, Company witness Joseph Gross testified that the work was for
31 rehabilitation as well as expansion.¹⁰ The Company also testified that it was compelled to commence

32 ⁶ Decision No. 5424 at 20.

33 ⁷ Company's Opening Brief at 20.

34 ⁸ Ex. A-1 at 13.

35 ⁹ Ex. A-2 at 11.

36 ¹⁰ Tr. 139:16-25.

1 the work in order to meet the planning requirements established by the Arizona Department of
2 Environmental Quality ("ADEQ"). While the Company must adhere to the standards established by
3 ADEQ with regard to the appropriate planning horizon, the Company controls its selection of a test
4 year. There is nothing to preclude the Company from filing a rate case to include the Wishing Well
5 Treatment facility.¹¹ Staff's treatment as post test year plant was appropriate.

6 **III. INCLUSION OF AIAC AND CIAC FOR PLANT IN CWIP.**

7 The Company's argument seeking to exclude Advances in Aid of Construction ("AIAC") and
8 Contributions in Aid of Construction ("CIAC") from rate base continues to be unpersuasive. AIAC
9 and CIAC are reductions to rate base as contemplated by Commission rules and should not be
10 accorded a different rate making treatment for Arizona-American.¹² The issue of AIAC and CIAC
11 associated with CWIP was raised most recently in the UNS Gas, Inc. rate application.¹³ In Decision
12 No. 70011, the Commission recognized that advances are properly deducted from rate base. Staff
13 continues to recommend that the CIAC and AIAC funds that the Company asserts are in CWIP be
14 reflected in the CIAC and AIAC balances used to calculate and properly reflect a reduction to rate
15 base, regardless of its form or how it is used.¹⁴

16 **IV. STAFF'S COST OF CAPITAL RECOMMENDATION PROPERLY RECOGNIZES**
17 **THE CURRENT ECONOMIC CLIMATE AND SHOULD BE ADOPTED.**

18 The Company argues that Staff's recommendation fails to reflect current market conditions.¹⁵
19 The methods used by the Company to derive its cost of equity ignore the realities of the current
20 market conditions. The Company simply ignores the relationship between economic conditions and
21 the cost of capital.

22 ...

23 ...

24 ...

25 ...

26 ¹¹ Tr. 428:5-23.

27 ¹² See AAC R14-2-103 Appendix B, Schedule B-1.

28 ¹³ Docket No. G-04204A-06-0463, Decision No. 70011.

¹⁴ Ex. S-8 at 10.

¹⁵ Company Opening Brief at 46.

1 The court held in *Bluefield*:

2 What annual rate will constitute just compensation depends upon many
3 circumstances and must be determined by the exercise of fair and
4 enlightened judgment, having regard to all relevant facts...A rate of
5 return may be reasonable at one time and become too high or too low
6 by changes affecting opportunities for investment, the money market
7 and business conditions generally.¹⁶

8 The Company seems to imply that as a regulated entity it should somehow be shielded from the
9 negative impacts of today's economy that affect its ratepayers and virtually every other business. It
10 would be unfair for the Company to claim that its risk and/or required return should be higher at this
11 time. Staff's cost of equity recommendation of 10% is consistent with recent Commission
12 decisions¹⁷ and results in the setting of just and reasonable rates, balancing the needs of the Company
13 and its ratepayers in the tradition of *Hope*.¹⁸

14 **V. RATE CONSOLIDATION PROPOSAL.**

15 Staff position regarding rate consolidation has not changed. Staff has reviewed Arizona-
16 American's proposal on how to best to accomplish rate consolidation of its districts.¹⁹ If the
17 Commission wishes to consider rate consolidation, Staff would offer as an alternative to the
18 Company's proposal that it may be possible to leave the current docket open for the sole purpose of
19 rate design for consolidation purposes, and at the time the Company files its next rate application,
20 move to consolidate the two dockets.

21 **VI. CONCLUSION.**

22 Staff respectfully requests the Commission to adopt its recommendations in this proceeding.
23
24

25 ¹⁶ *Bluefield Water Works v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).

26 ¹⁷ See Docket No. G-01551A-07-050, *In the Matter of the Application of Southwest Gas*, Decision
27 No. 70665 and Docket No. G-04204A-06-0463, *In the Matter of the Application of UNS Gas, Inc.*,
28 Decision No. 70011.

¹⁸ The Court stated: ... "the fixing of 'just and reasonable' rates, involves a balancing of the investor
and the consumer interests." *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 571, 64
S.Ct. 281 (1944).

¹⁹ Company Initial Brief at 51.

1 RESPECTFULLY submitted this 15th day of May, 2009.

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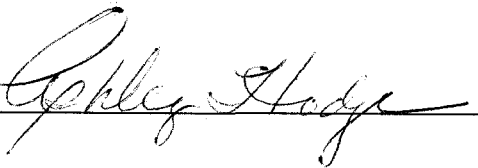
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